

BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

Changes Concerning Attributable Costing)
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Docket No. RM2016-13

**VALPAK DIRECT MARKETING SYSTEMS, INC. AND
THE VALPAK FRANCHISE ASSOCIATION, INC.
COMMENTS ON CHANGES CONCERNING ATTRIBUTABLE COSTING
(October 20, 2016)**

These Comments are submitted by Valpak Direct Marketing Systems Inc. and The Valpak Franchise Association, Inc. (hereinafter “Valpak”) in response to Commission Order 3507, together with a motion to file three days late.

I. Order No. 3507 Fails to Comport with a Major Aspect of Order No. 3506.

Order No. 3507 states:

Section 3633(a)(2) (competitive rate regulation) requires the Commission to ensure that “each competitive product covers its costs attributable.” 39 U.S.C. 3633(a)(2); see also 39 CFR 3015.7(b).4 Section 3631(b) defines attributable cost as “the direct and indirect postal costs attributable to [] product[s] through reliably identified causal relationships.” 39 U.S.C. 3631(b)

Additionally, under section 3622 (market dominant rate and class regulation), a product’s ability to cover its attributable costs is a factor to be considered when regulating rates for market dominant products and includes the same terminology, that postal costs should be attributed through reliably identified causal relationships, found in sections 3631(b). 39 U.S.C. 3622(c)(2).

Therefore, title 39 introduces the concept of attributable costs and describes the role they play in the regulation of both market dominant and competitive products. For competitive products, coverage of attributable costs is a requirement in regulating competitive product rates; **for market dominant products, it is only one of many factors the Commission considers when regulating market dominant rates.** See 39

U.S.C. 3633 (a)(2); 39 CFR 3015.7(b); 39 U.S.C. 3622(c).
[Order No. 3507 at 3-4 (emphasis added).¹]

Order No. 3506, issued concurrently with Order No. 3507, includes the following statement:

While each product's attributable cost will be equal to its incremental cost, marginal costs should remain the Postal Service's basis for setting prices, with the application of appropriate **markups to ensure that each product covers its incremental costs** and provides an appropriate share of institutional costs. Effectively, the average price of a product should meet or exceed the product's average incremental cost (the incremental cost divided by the number of pieces). **This would result in products having a cost coverage of 100 percent or greater.** [*Id.* at 61 (emphasis added).]

The above-quoted language makes no distinction between pricing principles applicable to competitive and market dominant products. Order No. 3506 speaks only of markups over marginal cost sufficient to exceed incremental cost and "cost coverage of 100 percent or greater." Additionally, it makes no mention of pricing below marginal cost, or cost coverage that is significantly and persistently less than 100 percent. In other words, the discussion in Order No. 3506 implies that the average revenue of every product, be it competitive or market dominant, henceforth will (or should) be required by the Commission to cover its incremental cost. Importantly, this would result in compliance with 39 U.S.C. § 101(d), which the

¹ The above bolded statement is an acknowledgment by the Commission of its tolerance for non-compensatory prices (*i.e.*, prices that do not provide revenue sufficient to cover a product's attributable cost, and often described as underwater products) of certain market dominant products such as Standard Flats and Periodicals, even when no real progress toward covering costs is made over a multi-year period.

Commission has found to be a constraint on Market Dominant pricing. *See* FY 2010 ACD at 106-07.

Order No. 3507 correctly requires that incremental cost be computed and used as the attributable cost of products (generally replacing marginal cost). It **fails**, however, **to require the pricing outcome it describes** in above-cost pricing. Neither a markup (on marginal cost) sufficient to equal or exceed incremental cost, nor a cost coverage of at least 100 percent, is expressly required by Order No. 3506. In the absence of explicit language requiring such an outcome, lengthy experience under PAEA with underwater products — products that do not cover even marginal cost — indicates that cost coverage equal to or exceeding (new, higher) attributable cost will not come to pass, *i.e.*, left to its own devices, the Postal Service will not make it happen.

Valpak therefore strongly recommends that the Commission's Rules be revised to mandate at least near term 100 percent coverage of attributable (incremental) cost for all market dominant products, as well as all competitive products. Accordingly, Valpak proposes that the Commission also include the following changes to the Commission's Rules:

§ 3010.4 Type 1-A rate adjustment—in general.

* * *

(d) For any product which the Commission has determined has a cost coverage of less than 100 percent in the most recent Annual Compliance Determination, the Postal Service shall begin the process of transitioning such product to full incremental cost coverage within two years beginning with its next Type 1-A rate adjustment.

If the foregoing proposed language is rejected, then at a minimum, the Commission should define “attributable costs” as “incremental costs” in its Rules addressing costs for market dominant products, as follows:

§ 3050.1 Definitions applicable to this part.

* * *

(h) *Attributable costs* includes a product’s volume-variable costs, product-specific costs, and those inframarginal costs calculated as part of a competitive product’s incremental costs.

Valpak acknowledges that PAEA gives the Postal Service certain pricing flexibility — but only for prices within the law. Valpak does not believe though that Postal Service pricing flexibility should be interpreted as encompassing non-compensatory pricing strategies that are discriminatory or unfair and which tilt the playing field and deliberately favor some mailers at the expense of others, or otherwise violate the dictates of 39 U.S.C. § 101(d) and § 404(b). It is grossly unfair to make profitable mailers subsidize the handling, transportation and delivery costs which other mailers “cause” the Postal Service to incur. Basic fairness should require the Commission to mandate rates that at least cover the incremental costs of handling, transporting and delivering mail which the Postal Service incurs on account of each product, *i.e.*, all rates should be compensatory.

If, however, the Commission nevertheless is willing to continue tolerating underwater products whose average revenue is “marked down,” or discounted, below attributable cost, at least during a transitional period, then in fairness to those mailers forced to provide the cross-subsidy, the Commission should mandate a minimum level of accountability. For example, the

Postal Service should be required to justify the “negative markdown” or “discount” pricing strategy for each underwater product by providing detailed citations to the economic literature that explain the circumstances under which it can be considered applicable. Here, the input of the Federal Trade Commission could be sought as to the “net economic effect” of underwater pricing on the Postal Service and other mailers. Mailers paying unduly high markups necessitated by the need to fund the subsidy to underwater products are entitled to a comprehensive explanation of the market justification relied upon by the Postal Service to ensure these pricing subsidies are not doled out to favored mailers for improper, illegitimate, or other reasons that would be arbitrary or in violation of applicable law.

II. Former Utility Regulators Note That (i) Cross Subsidies Harm Those Captive Customers Forced to Subsidize Others, and (ii) Regulators Have a Duty to Protect Monopoly Customers from Such Exploitation.

In Docket No. PI2016-3, Section 701 Report, Comments of Former Utility Regulators (filed 6/15/2016) submitted *Cross-Subsidization: Applying Lessons from Utility Regulation to the United States Postal Service*, a paper authored by Bryan Tramont, Raymond Gifford and Gregory Sopkin and endorsed by a number of other former regulators.

The “danger,” specifically, is not just that monopoly-subsidized competitive offerings distort competition in the competitive sector, but more principally, that such **cross subsidies harm customers paying for the monopoly regulated services**. In the utility context these customers have long been referred to as “ratepayers,” and often, “captive ratepayers,” **the notion being that they have no choice but to pay the rates that the monopoly provider charges** for utility service, as there is no alternative competitive provider. Accordingly, utility regulators have recognized in any number of contexts the danger that the utility may be inclined to overstate costs on the regulated side, leaving captive ratepayers no choice but to pay those rates. And overstated costs on the regulated side of the ledger means

understated costs for competitive products, potentially allowing utilities to unfairly price competitive offerings below cost. [*Id.* at 3-4 (emphasis added).]

The discussion by former utility regulators admittedly is concerned with possible cross-subsidization of competitive products by monopoly products. In the case of the Postal Service, it has not over-attributed costs, but it has overpriced products. The Postal Service has minimized cost attribution and exercised the arbitrary power to impose the burden of unattributed costs on selected products.

From the perspective of a customer forced to pay a price significantly higher than warranted in order to fund the requisite subsidy, it makes little difference whether the extra revenue so extracted goes to cross-subsidize a competitive product (which the law explicitly prohibits) or another competing market dominant product. For customers who are forced to overpay in support of lower prices on products of others, the harm from overpayment is the same.

Valpak believes that regulators, including the Commission, have a duty to protect captive ratepayers from such overpricing. The Commission ought to give all mailers equal protection from any Postal Service pricing scheme that requires subsidization of some mailers and overpricing of others. The way to achieve this is to require that revenue from every product cover its attributable (incremental) cost, as Order No. 3506 correctly states.

CONCLUSION

For the foregoing reasons, the Commission should amend its Rules with respect to market dominant products to require that prices exceed incremental costs.

Respectfully submitted,

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